

Message Text

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ACTION ARA-10

INFO OCT-01 EUR-12 IO-10 ISO-00 ARAE-00 XMB-02 OES-03

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TO SECSTATE WASHDC PRIORITY 4504

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USMISSION MTN DELEGATION GENEVA

C O N F I D E N T I A L SECTION 1 OF 2 LIMA 2516

EO 11652: GDS

TAGS: EGEN, ETRD, EAGR, ECON, EAID, PE

SUBJECT: EMBASSY/USAID REVIEW OF IBRD ECONOMIC
REPORT ON PERU (REPORT NO. 655-PE) AND LIST
OF PROJECTS FOR EXTERNAL FINANCING

ATTN: ARA/LA-EP; RICHARD WEBER

1. REFERENCED REPORT OF MARCH 3, 1975 OUTLINES MAJOR PROBLEMS
FACING PERUVIAN ECONOMY AND SPECIFIES POLICY MEASURES RE-
QUIRED FOR SUCCESSFUL IMPLEMENTATION OF PERU'S INVESTMENT
PLANS WITHOUT UNDUE INTERNAL AND EXTERNAL ECONOMIC INSTABILITY.
THE BANK RECOMMENDS A CLASSICAL AUSTERITY PROGRAM TO LAST
UNTIL 1977 WHEN SUBSTANTIAL EXPORT PROCEEDS ARE EXPECTED. THE
EMBASSY AND MISSION GENERALLY AGREE WITH THE ECONOMIC ANALYSIS
OF THE REPORT AND THE REMEDIAL MEASURES SUGGESTED, BUT WE
DIFFER WITH SEVERAL UNDERLYING ASSUMPTIONS, WITH SOME OF
THE DATA, AND CONSEQUENTLY WITH SEVERAL OF THE REPORT'S
CONCLUSIONS ABOUT PERU'S FUTURE PROSPECTS. COMMENTS AND
OBSERVATIONS FOLLOW:

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2. ABSORPTIVE CAPACITY: WE BELIEVE THAT PROJECT IMPLEMENTATION MAY PRESENT SERIOUS PROBLEMS FOR GOP BECAUSE THE OBSORPTIVE CAPACITY OF PERU IS SUBSTANTIALLY MORE LIMITED THAN THE BANK BELIEVES. OUR OWN EXPERIENCES WITH PROJECT DESIGN AND IMPLEMENTATION AND REPORTS FROM OTHER ASSISTANCE AGENCIES BEAR OUT THIS CONCLUSION. PUBLIC SECTOR MANAGEMENT REQUIREMENTS ARE GROWING RAPIDLY BUT A SERIOUS LACK OF TRAINING PROGRAMS AND SUFFICIENTLY ATTRACTIVE SALARIES PREVENT MOST PRIVATE SECTOR MANAGERS FROM SEEKING TO FILL THESE POSITIONS. WE THEREFORE CONCLUDE THAT THE RESULTANT DELAYS IN PROJECT EXECUTION COULD SLOW BOTH THE PLANNING AND IMPLEMENTATION OF THE GOP'S INVESTMENT PROGRAM IN THE NEAR FUTURE. TURNKEY PROJECTS PERFORMED BY FOREIGN FIRMS, OR PROJECTS INVOLVING FOREIGN MANAGERIAL CONTRACTS, OBVIOUSLY INVOLVE LESS OF A PROBLEM.

3. NATIONAL SAVING: WE BELIEVE THE TARGETS RECOMMENDED IN THE REPORT FOR A MARGINAL SAVING RATE OF 30 PERCENT AND THAT REAL PRIVATE CONSUMPTION SPENDING GROWTH MIGHT BE REDUCED FROM 9 PERCENT TO 5 PERCENT ARE UNREALISTIC. ON THE CONTRARY, THE INCREASING RATE OF INFLATION, SOME REDISTRIBUTION OF INCOME, LACK OF INVESTMENT ALTERNATIVES AND THE GENERAL LEVEL OF UNCERTAINTY REGARDING THE FUTURE OF PRIVATE PROPERTY, AND CONSEQUENTLY OF IDLE BALANCES, ARE ALL RESPONSIBLE FOR THE CURRENTLY HIGH MARGINAL PROPENSITY TO CONSUME. SINCE THE REPORTS OVERALL POSITIVE CONCLUSIONS ARE BASED ON A SUBSTANTIAL INCREASE IN NATIONAL SAVINGS, WE PREDICT THAT BOTH THE BOP AND BUDGETARY DEFICITS 1975-77 WILL EXCEED BANK ESTIMATES AS WILL THE RATE OF INFLATION. THE PARTIAL REDUCTION IN SUBSIDIES RESULTING FROM RECENT PRICE INCREASES WILL HELP, HOWEVER LARGE SUBSIDIES REMAIN ON MANY BAIC AGRICULTURAL PRODUCTS AND THE PRICE OF GASOLINE REMAINS LOW DESPITE THE LARGE INCREASE IN INTERNATIONAL PETROLEUM PRICES. THE GOVERNMENT HAS ANNOUNCED THAT GASOLINE PRICES WILL BE INCREASED BEFORE THE END OF JUNE. THE EMBASSY EXPECTS THAT PUBLIC ANNOUNCEMENT TO BE MADE PRIOR TO THE CONSULTATIVE GROUP MEETING.

4. INFLATION: THE REPORT'S ESTIMATE OF ANNUAL 20 PERCENT INFLATION OVER 1975-76 IS TOO LOW. GOP ECONOMISTS PRIVATELY ADMITTED THAT THEY CAN ONLY HOPE TO KEEP THE RATE UNDER 25 PERCENT THIS YEAR, CONFIDENTIAL

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WHICH IS PROBABLY UNLIKELY. FURTHER PRICE INCREASES ON IMPORTS, CONTINUED SHORTAGES OF BASIC CONSUMER GOODS, ESPECIALLY FOOD ITEMS, THE LAGE BUDGET DEFICIT, RECENTLY DECLARED PRICE INCREASES ON BASIC FOOD ITEMS, THE EXPECTED INCREASE IN GASOLINE PRICES, LACK OF VALUE MAINTENEANCE ON SAVINGS, FEAR OF FUTURE PRICE INCREASES, SLOW PRODUCTIVITY GROWTH IN MOST SECTORS OF THE ECONOMY, AND INCREASINGLY STRIDENT WAGE DEMANDS FROM LABOR UNIONS AND PUBLIC SECTOR EMPLOYEES WILL

PUSH PRICES UP BY AT LEAST 25 PERCENT IN 1975 AND BY 28 PERCENT
IN 1976 IN OUR OPINION.

5. BOP AND INTERNATIONAL RESERVE LOSS: IN CONTRAST TO THE
\$200 MILLION LOSS OF RESERVES OVER THE TWO YEAR PERIOD
ESTIMATED IN THE REPORT, WE FORESEE A MODERATE LOSS OF
RESERVES THIS YEAR FOLLOWED BY A LARGER LOSS IN 1976 AS THE
BOP DETERIORATES. WE ESTIMATE THAT THE LOSS MAY EXCEED
\$400 MILLION FOR THE TWO YEARS. THE REPORT FAILS TO DISCUSS
THE LARGE SHORT-TERM CAPITAL INFLOW IN 1974 RESULTING FROM THE
SHORT-TERM CREDIT REQUIREMENTS IMPOSED ON IMPORTERS EARLY
IN THE YEAR. THE GOP HAS ASSURED THE IMF THAT IT INTENDS TO
ELIMINATE THESE REQUIREMENTS WHICH COULD CAUSE A LARGE SHORT-
TERM CAPITAL OUTFLOW.

6. BOP, OIL, AND BUDGET RELIEF; THE REPORT IS VERY OPTIMISTIC
RE GENERATION OF ADDITIONAL FOREIGN EXCHANGE AND BUDGETARY
RECEIPTS THROUGH INCREASES IN MINERALS AND PETROLEUM EXPORTS,
STARTING IN 1977. IN PARTICULAR, THE REPORT ASSUMES THAT
PERU'S PROVEN OIL RESERVES WILL BE LARGE ENOUGH TO
GENERATE FOREIGN EXCHANGE EARNINGS IN 1977. NEITHER WE
NOR SEVERAL KNOWLEDGEABLE GOP OFFICIALS BELIEVE THIS WILL
BE LIKELY, SINCE THERE ARE NEITHER SUFFICIENT PETROLEUM
RESERVES AS YET PROVEN NOR HAVE QUESTIONS REGARDING THE
OCCIDENTAL SPUR LINE BEEN RESOLVED. WE DO NOT BELIEVE THAT
THE OIL PIPELINE PLUS THE OCCIDENTAL SPUR ARE LIKELY TO BE
FINISHED UNTIL 1977 AT THE EARLIEST. WE ALSO QUESTION THE
PETROLUUM PRICE TRENDS AS FORECAST IN THE REPORT WHICH
APPEAR HIGH ALTHOUGH WE RECOGNIZE THE UNCERTAINTY OF THESE
ESTIMATES.

7. EASIER TERMS ON FOREIGN LOANS. OUR INFORMATION LEADS
US ALSO TO QUESTION THE REDUCTION IN THE INTEREST RATE SPREAD
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OVER LIBO AS MENTIONED IN THE REPORT. RECENT LOANS HAVE
VARIED FROM 1 7/8 TO 2.5 PERCENT OVER LIBO. ALSO, WE DOUBT THAT
CONCESSIONAL (OFFICIAL) LENDING WILL INCREASE TO 55 PERCENT OF
TOTAL BORROWING DURING THE TWO YEAR PERIOD WHICH IN TURN WOULD ALLOW
FOR EASING OF AVERAGE CREDIT TERMS.

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8. AGRICULTURE: PER CAPITA FOOD PRODUCTION IN PERU WILL PROBABLY CONTINUE TO FALL, ALTHOUGH RECENT ON-FARM PRICE INCREASES MAY EASE THE SITUATION marginally. WE THEREFORE CONCLUDE THAT NON-PROJECT LOAN DISBURSEMENTS TO FINANCE FOOD IMPORTS AND REFINANCE THE DEBT WILL SUBSTANTIALLY EXCEED THE \$390 MILLION PROJECTED IN THE REPORT FOR 1975-76. PERIODIC SHORTAGES OF BASIC FOOD ARE EXPECTED TO CONTINUE. THE REPORT IGNORES, FOR THE MOST PART, THE PROBLEM OF SCARCITY OF FERTILIZER, AND PINS ITS HOPES ON INCREASED DOMESTIC PRODUCTION TO MEET PERU'S NEEDS. WE DOUBT THAT THESE PLANTS WILL BE ON LINE IN 1975 OR COVER PERU'S NEEDS BY 1976.

9. WE WISH TO CALL ATTENTION TO PAGE 28 OF TABLE 4.2 OF REPORT WHICH WE ARE UNABLE TO RECONCILE WITH ANY AID FIGURES. IF SIMILAR ERRORS EXIST FOR OTHERS DONORS, ALL HISTORIC DISBURSEMENT FIGURES AS WELL AS PROJECTIONS MUST BE QUESTIONED. SUGGEST AID/W CHECK THIS POINT WITH IBRD STAFF.

10. FINALLY, WITH RESPECT TO LIST OF PROJECTS, WE WERE STRUCK BY SIZE OF SHOPPING LIST CONTAINED IN TABLE 1 - ITS VERY HEAVY
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EMPHASIS ON MINING AND INDUSTRY, AS OPPOSED TO RELATIVELY LITTLE EMPHASIS ON AGRICULTURE AND VIRTUALLY NONE IN SOCIAL SECTORS OF HEALTH, EDUCATION, AND WATER SUPPLY. THIS TENDENCY EVEN MORE EVIDENT IN LISTING OF PRIORITY PROJECTS (TABLE 4).

WE ALSO NOTE THAT 69 PERCENT OF PRIORITY PROJECTS ARE WITHOUT IDENTIFIED POTENTIAL DONORS, WHICH CASTS FURTHER DOUBT ON IBRD'S HOPE THAT 55 PERCENT OF TOTAL BORROWING WILL BE CONCESSIONAL.

FURTHER ANALYSIS ON PROJECT LISTING FOLLOWS SEPTTEL, BUT WE SUGGEST THAT YOU MAY WISH TO EXPLORE WITH EXIM THEIR INTEREST IN FINANCING TRANSPORTATION PROJECTS VI-4 AND VI-10, AS WELL AS HEALTH LOANS X-1 AND X-3.

11. COMMENTS: THE FOREGOING HAS BEEN PREPARED TO ASSIST IN PLANNING FOR THE FORTHCOMING APRIL CONSULTATIVE GROUP MEETING ON PERU IN PARIS. WE UNDERSTAND, IN PARTICULAR, THAT THE IBRD AND PERU EXPECT DONOR COUNTRIES TO RAISE QUESTIONS CONCERNING PERU'S POTENTIAL PETROLEUM PROSPECTS, AND THE BASIS FOR THEIR RATHER OPTIMISTIC ESTIMATES IN REGARD TO THIS AND OTHER POINTS.
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